

**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION**

United States of America, et al.)	
)	
Plaintiffs,)	
)	
v.)	Case No. 1:02cv00107
)	(Consol. with C-1-02-108 and
)	C-1-02-135)
The Board of County Commissioners, Hamilton County, Ohio)	
)	Judge Arthur J. Spiegel
)	Magistrate Judge Timothy S. Hogan
Defendants.)	
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DEFENDANTS' MEMORANDUM ACCOUNTING FOR EXPENDITURES

Defendants respectfully submit this Memorandum Accounting for Expenditures in response to the Court's Order dated January 27, 2004, as amended January 30, 2004 (collectively the "Order"). In the Order, the Court stated that it understood that funds had been "earmarked for the correction of the Hamilton County sewer system since 1990 by the federal, state, and county governments, which are in excess of that amount necessary to operate the sewer system." Order at 1.

At the outset, Defendants respectfully note that management of the financial affairs of the Metropolitan Sewer District of Greater Cincinnati ("MSD") is a highly complex undertaking that is overseen by both the Board of County Commissioners and the City of Cincinnati, as well as subject to independent annual audits that are conducted by Certified Public Accountants and approved by the Auditor of the State of Ohio. *See, e.g.*, Letter from Auditor of State to Board of County Commissioners (June 18, 2003) (attached hereto as Exh. 1). Because Defendants do not maintain separate accounts specifically "earmarked for correction of the Hamilton County sewer

system," and because all expenditures directly or indirectly impact Defendants' Clean Water Act compliance efforts, this Memorandum will provide the Court with a summary description of its financial management system and an overview accounting of its expenditures since 1990. Supporting documentation is attached with additional detail should the Court wish to explore these issues further. *See* Appendix A (List of Exhibits).

I. Description of MSD's Finances

A. Revenues

From 1990 to today, the costs of operating, maintaining, and financing Defendants' sewer system and improvements have been met primarily with user fees.¹ User fees are collected by the City and placed in a cash "Operating Fund" on behalf of the County, and are used to pay for MSD's operations and maintenance expenses, as well as the principal and interest on debt obligations. *See* 2003 Bond Prospectus at 9-10 (attached hereto as Exh. 14) (providing additional detail). Revenues must be sufficient to meet the cash requirements of: (1) the routine operation and maintenance of the sewer system; (2) principal, interest, and reserve payments on revenue bonds and other indebtedness; (3) debt service coverage obligations;² and (4) recurring capital expenditures that are not debt financed.

¹ *See* Black & Veatch, "Report on Wastewater Rates" at 13 (providing more detailed breakdown of revenue sources) (attached hereto as Exh. 15). Further information is contained in the attached audited financial statements (attached hereto as Exhs. 2-13). Defendants also attach Hamilton County's most recent sewer revenue bond prospectus, which has additional information regarding revenues (attached hereto as Exh. 14).

² Debt service coverage is required as a condition of the revenue bonds that Hamilton County periodically issues for sewer system improvements. As discussed in more detail in the 2003 Bond Prospectus at 10-11 (attached hereto as Exh. 14), Defendants' annual available net income from sewer system operations must exceed 125% of the annual principal and interest payable on the bonds. *See, e.g.*, 2002 Financial Statements at 22-23 (calculating debt service

B. Management of Revenues in Accounts

Revenues collected by Defendants are placed in two general types of accounts:

(1) "Mission" Accounts used by Defendants to manage monies used to execute MSD's mission of collecting and treating wastewater; and (2) "Reserve" Accounts required to meet financial obligations imposed in connection with Defendants' bond issuances.

1. "Mission" Accounts

There are three accounts used to manage funds spent by Defendants to achieve MSD's mission. Revenues from user fees, such as service charges and surcharges, are placed in the **Operating Fund** and fund day-to-day expenses of MSD. Once a year, excess cash in the Operating Fund, defined as greater than two months of operations and maintenance expense, is transferred to the **Surplus Account**.³ Most of the money in the Surplus Account, however, is comprised of bond proceeds. The third "Mission" account is the **Construction Account**, which is used to fund Capital Improvements and draws its funds primarily from the Surplus Account. The year-end amounts in these funds are recorded in the audited and approved financial statements. *See* Exhs. 2-13.

2. "Reserve" Accounts

In connection with their issuance of revenue bonds, Defendants must establish certain trust accounts, along parameters that are more fully described in the attached bond prospectus

[Footnote continued from previous page]

coverage) (attached hereto at Exh. 2). Historically, Defendants have maintained higher than required debt service coverage in order to maintain a strong credit rating and maximize the County's ability to issue bonds with acceptable rates.

³ Annual transfers to the Surplus Account are indicated in MSD's annual audited financial statements in the Statements of Net Assets as "Amount to be transferred to surplus account." (attached hereto at Exhs. 2-13); *see also* 2003 Bond Prospectus at 10-11, 50 (explaining mechanisms of transfer and Trust Agreement requiring transfer) (attached hereto as Exh. 14).

and the notes to the financial statements. *See, e.g.*, 2003 Bond Prospectus at 9-11, 48-58 (attached hereto at Exh. 14); 2002 Financial Statements at 16-17, 20-24 (attached hereto at Exh. 2). These accounts include: (1) the Bond Account (used to accumulate periodic principal and interest payments); (2) the Bond Reserve Account (funded to an amount equal to the highest annual future debt service requirement); and (3) the Replacement and Improvement Account (to be maintained at a balance of \$5,000,000).

C. Expenditure Categories

Expenditures generally fall into two categories: (1) operation and maintenance expenditures; and (2) capital expenditures.

1. Operation and Maintenance Expenditures

Operation and maintenance expenditures include: (1) employee salaries and benefits; (2) contractual services and material costs unrelated to capital projects (*e.g.*, auditors' fees and wastewater treatment chemicals); and (3) utility costs (*e.g.*, electricity, natural gas, etc.). As noted above, Operation and Maintenance expenditures are paid out of the Operating Fund.

2. Capital Expenditures

Capital expenditures pay for two basic categories of projects: (1) those that are routine, such as equipment replacement costs, which are financed out of annual revenues; and (2) those that are known as "Capital Improvements." Capital Improvements include items such as sanitary sewer overflow ("SSO") and combined sewer overflow ("CSO") remedial measures, new sewers, sewer replacements, treatment plant upgrades, and building acquisition.

As discussed above, Capital Improvements are generally paid for by the Construction Account, which is principally funded by transfers from the "Surplus Account." Bond issues are the primary mechanism by which the Surplus Account is reimbursed for Capital Improvement

expenditures.⁴ In other words, bond revenues "pay for" Capital Improvements, the costs of which have been or are being incurred. Bonds obligations ultimately are repaid by operating revenues (*i.e.*, fees paid by ratepayers) through payments on interest and principal. Thus, capital projects, like other expenditures, have the same source of revenue.

Defendants operate a "Capital Improvement Program" ("CIP") to help prioritize the construction of Capital Improvements. Under the Capital Improvement Program, MSD develops five-year and one-year plans for projects, and will prioritize capital projects according to a variety of factors, including relative needs for each improvement and time required for planning, design, and easement acquisition. The existence of regulatory requirements driving a particular project will also affect prioritization. The one-year and five-year CIP Plans include estimated costs and proposed methods of financing. Each year, the Board of County Commissioners votes on the Program as a whole. Before any funds may be expended, however, the Board of Commissioners must approve expenditures at public meetings before each stage (*e.g.*, study, design, and construction) of an individual project. *See* 2003 Bond Prospectus, Exh. 14 at 35-37 (discussing capital program).

⁴ Capital Improvements are sometimes paid for with loans and grants, as well. The federal government reimbursed Defendants \$1,282,102 in 1990, \$1,434,760 in 1991, and \$393,262 in 1992, for capital expenditures devoted to projects on the Mill Creek Treatment Plant, stemming from the 1985 Consent Order. This money was part of a larger grant awarded prior to 1990.

Defendants also received \$16,421,477.26 between 1990 and 2003 from the Ohio Water Pollution Control Loan fund for qualified loan projects on sewer replacements/repairs and sewer overflow projects. Defendants also received \$4,076,155.97 in loans from the Ohio Public Works Commission for qualified projects, largely involving "trenchless technology" sewer line repair. Project costs from each loan source were paid directly by the State after capital costs were incurred (thus, the cost of the projects equaled the size of the loans).

II. Accounting of Expenditures

The following tables summarize the Defendants' historical expenditures. Table A includes Defendants' historical revenues, expenditures, and bond proceeds for the purpose of funding Capital Improvements between 1990 and 2002.⁵ Table A was compiled using MSD's independently audited annual financial statements, which are approved by the Auditor of the State of Ohio. *See* Exhs. 2-13. Table A should be read together with the notes in those statements and the principles of accounting used to generate the figures. The meaning of each column is explained below the Table.

**Table A: Overview of Revenues, Expenditures, and Bond Issues
for Capital Projects**
(all amounts are dollars expressed in thousands)

	Annual Revenues	Total Operating and Maintenance Expenses	Principal and Interest Obligations on Long Term Debt		Proceeds from Bond Issues for Reimbursement of Prior and Uncompleted Projects	Capital Expenditures (Construction, acquisition, etc.)
1990	\$ 78,421	\$ 53,397	\$ 16,362			\$ 16,431
1991	86,727	53,403	18,201		\$ 45,052	18,961
1992	84,628	56,520	18,555			36,977
1993	96,328	58,215	22,500		45,000	30,446
1994	103,093	65,245	20,609			41,145
1995	104,953	65,909	21,479		60,000	48,341
1996	113,566	67,060	25,884			48,097
1997	111,781	69,758	26,083		97,473	35,072
1998	118,495	66,605	31,743			37,253
1999	115,016	63,379	31,747			62,838
2000	120,601	67,507	35,325		36,241	38,021
2001	127,707	70,312	36,923		56,981	34,619
2002	130,997	75,436	40,859			32,277

⁵ 2002 is the most recent year that MSD has approved and independently audited financial statements; Table A is limited so as to include only audited figures.

The figures in the "**Annual Revenue**" column are taken from the "Long-Term Debt" Note to the annual financial statements at Exhibits 2 through 13, and are listed there as "Total pledged revenues." This includes total operating revenue, interest income, capitalized interest income, and fees generated from tap-ins/connections. Annual revenues do *not* include changes in fair value of assets, sales of assets, capital raisings, or physical capital contributions (for example, value of improvements donated by developer).

The figures in the "**Total Operating and Maintenance Expenses**" column are taken from the "Long-Term Debt" Note to the annual financial statements at Exhibits 2 through 13, and are listed there as "Total operating and maintenance expenses less depreciation and amortization."

The figures in the "**Principal and Interest Obligations on Long Term Debt**" column are taken from the "Long-Term Debt" Note to the annual financial statements at Exhibits 2 through 13, under the category "Principal and interest requirements on all obligations."

The figures in the "**Bond Issues for Reimbursement for Prior and Uncompleted Projects**" column are taken from the Application of Proceeds section of each historical bond prospectus.

The figures in the "**Capital Expenditures (Construction, acquisition, etc.)**" column are taken from the "Acquisition and Construction of Capital Assets" line in the annual "Statements of Cash Flows" found in the annual financial statements at Exhibits 2 through 13. This figure is a total of all cash payments by Defendants that were identified by its audited financial system as being for capital expenditures, which as discussed above, include SSO remedial measures, CSO remedial measures, new sewers, treatment plant upgrades and, facilities acquisition.

Table B contains a breakdown of Defendants' accounting of capital expenditures for Capital Improvement Projects by classification type since 1997.⁶

For the purposes of this submittal, MSD engineers reviewed the history of each Capital Improvement Project with expenditures incurred between 1997 and 2002 (there were approximately 550 Capital Improvement Projects undertaken during this time period) and classified them according to category type, as discussed below Table B. Once classified, the total accounting for all capital expenditures by projects of particular classification was summed for each year, and these figures are reported in Table B.⁷

⁶ Table B was compiled using a "Work In Process" report, which is an Excel spreadsheet that MSD's accountants create to summarize the accounting for capital expenditures on each Capital Improvement Project on a per annum basis. Prior to 1997, MSD used different electronic software to track capital expenditures and did not create annual summaries of capital expenditures on a per project basis. Thus, for years prior to 1997, MSD does not have annual summaries or capital expenditure information in a format readily available for Defendants' use to create Table B.

⁷ Defendants' Capital Improvement Program classifies Capital Improvement Projects by a classification scheme. MSD looked at the actual history of these projects, rather than relying on the classifications in the annual Capital Improvement Program. There are three reasons for this. First, Defendants' classification system changed in 2000 to include a designation for SSO projects, whereas prior to 2000, these projects were classified under a broader designation that included other types of projects. Thus, a review of each Capital Improvement Project's actual history was required to ensure uniform designations throughout the time period 1997 to 2002. Second, Capital Improvement Program designations—made prior to construction—may not reflect the project finally constructed. For example, projects that were initially designated to replace a sewer may have been modified to upgrade a sewer to increase capacity and eliminate SSOs, and thereby were appropriately designated as "SSO Projects" for the purpose of constructing Table B. Third, projects often have multiple effects, and might be designated in the Capital Improvement Program as one type, though they more appropriately fall in a different category under the protocol defined for Table B.

**Table B: Breakdown of Capital Expenditures on Capital Improvement
Projects Relating to Sewer Overflows (including WIBs)
and Treatment Plants**

(all amounts are dollars expressed in thousands)

	SSO Projects	CSO Projects	Treatment Plant Projects	Sewer Lining, Rehabilitation, and Replacement Projects
1997	\$ 8,660	\$ 2,136	\$ 13,786	\$ 10,735
1998*	9,521	1,303	9,809	8,901
1999*	7,586	9,594	26,034	18,154
2000	5,513	5,572	15,988	7,782
2001	8,308	1,869	10,737	8,521
2002	10,109	1,546	3,809	10,809

"**SSO Projects**" include WIB projects performed on a sanitary line; pump station projects that were designed to eliminate overflows from sanitary sewer lines; and sewer upgrades or construction of relief sewers that increase system capacity, thereby reducing the likelihood of (or eliminating) SSOs.

"**CSO Projects**" include projects designed to address CSOs and capacity-related WIBs for properties served by combined sewers. Such projects might include sewer separation, upgrades of the combined sewer to address WIBs, and modifying CSO facilities.

"**Treatment Plant Projects**" are projects designed to upgrade treatment processes and performance.

"**Sewer Lining, Rehabilitation, and Replacement Projects**" include projects where sewers were replaced or lined because of their damaged physical condition, which was sometimes causing overflows, or would have caused overflows in the future if those sewers were

* For historical reasons relating to a bond issue and an audit, the information for the year 1998 is from the eleven-month period from January 1, 1998 to November 30, 1998. Information for the year 1999 contains December 1998 expenditures in addition to the twelve months in 1999. All other years express calendar year expenditures.

not repaired or replaced. Sewer replacement and lining projects also reduce inflow and infiltration, and thus these projects reduce the possibility of overflows during rain events. This category also includes projects that upgraded pump stations, eliminated pump stations, and upgraded or eliminated package treatment plants.

MSD also incurs additional capital expenditures for Capital Improvement Projects unrelated to the categories listed above and not listed in Table B, such as upgrades to building facilities and new sewer projects. In addition, MSD incurs other capital expenditures unrelated to the Capital Improvement Program, such as computer purchases.

III. Environmental Security Account Established under 1985 Consent Order

As the Court is aware, an Environmental Security Account was created pursuant to the Consent Order between the United States, the State of Ohio, ORSANCO, and Defendants entered in 1985. This fund started with a balance of \$750,000. Since its inception, the fund has been segregated in a checking account and invested in Certificates of Deposit. Because of the need to have access to the money if a project was approved pursuant to the 1985 Consent Order, the Certificates of Deposit were staggered and short-term.

Monies were expended from the Environmental Security Account in 1988, 1989, and 1990 on an approved project inventorying volatile organic compounds ("VOCs") in the Little Miami portions of the sewer system, and studying the fate of VOCs in the system. Expenditures in these years equaled \$92,464; \$144,359.06; and \$54,377.24, respectively. The end of the year fund balance as reported in the audited and approved financial statements for MSD (Exhs. 2-13),

rounded to the nearest thousand, for the years between 1990 and 2002 were as follows:

1990	\$701,000
1991	\$743,000
1992	\$773,000
1993	\$790,000
1994	\$816,000
1995	\$859,000
1996	\$902,000
1997	\$947,000
1998	\$993,000
1999	\$1,038,000
2000	\$1,092,000
2001	\$1,144,000
2002	\$1,166,000

As of December 31, 2003, the fund totaled \$1,177,151.06. Of this money, \$33,565 was in a checking account, \$895,830.38 was in a six-month Certificate of Deposit, \$105,491.31 was in a three-month Certificate of Deposit, and \$142,263.82 was in a separate three-month Certificate of Deposit. This fund will be closed out, as this money will be used as the seed money for the new Water-in-Basement program. *See* Proposed Global Decree at § XII.B (Docket # 101).

IV. Conclusion

Defendants' finances for operation of the Metropolitan Sewer District are complex—largely because of the level of oversight inherent in the various covenants that restrict the County's use of proceeds. Independent audits are annually performed, and approved by the

Auditor of the State of Ohio. Should the Court desire additional information regarding the District's expenditures, Defendants will provide the Court with information on an achievable timeline.

Dated this 9th day of February, 2004.

s/Nee Fong Chin

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For the Board of County Commissioners of
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Cincinnati

CERTIFICATE OF SERVICE

The undersigned certifies that on February 9, 2004, he electronically filed the foregoing Defendants' Memorandum Accounting for Expenditures and supporting exhibits. The undersigned understands that each party in this matter has registered for the Court's Electronic Case Filing service, and thus has received copies of Defendants' Memorandum Accounting for Expenditures and supporting exhibits contemporaneously with the electronic filing. In addition, the undersigned certifies that he caused to be served, by hand delivery, a true and correct courtesy copy of this Memorandum and supporting exhibits to the offices of D. David Altman at the following location:

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s/Kevin St. John

Kevin M. St. John

APPENDIX A: LIST OF EXHIBITS

EXHIBIT	DOCUMENT
1.	Letter from Auditor of State of Ohio to Board of City Commissioners (June 18, 2003)
2.	Financial Statements for the years ended December 31, 2002 and 2001
3.	Financial Statements for the years ended December 31, 2001 and 2000
4.	Financial Statements for the years ended December 31, 2000 and 1999
5.	Financial Statements and Independent Auditors' Report for the years ended December 31, 1999 and 1998
6.	Financial Statements and Independent Auditors' Report for the years ended December 31, 1998 and 1997
7.	Financial Statements and Independent Auditors' Report for the years ended December 31, 1997
8.	Financial Statements and Independent Auditors' Report for the years ended December 31, 1996
9.	Financial Statements and Independent Auditors' Report for the years ended December 31, 1995
10.	Financial Statements and Independent Auditors' Report for the years ended December 31, 1994
11.	Financial Statements and Independent Auditors' Report for the years ended December 31, 1993
12.	Report Audit of Financial Statements for the years ended December 31, 1992 and 1991
13.	Report Audit of Financial Statements for the years ended December 31, 1991 and 1990
14.	2003 Series Hamilton County, Ohio Sewer System Improvement and Refunding Revenue Bonds (2003 Bond Prospectus)
15.	Black & Veatch, Report on Wastewater Rates (April 2003)